U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

September 19, 1996

MORTGAGEE LETTER 96-52

TO: ALL APPROVED MORTGAGEES

SUBJECT: Single Family Loan Production - Nonprofit Agencies as Mortgagors

Nonprofit agencies have long been important and active partners with FHA in developing affordable housing. Combining the credit enhancement of FHA mortgage insurance with their local expertise as housing providers, these agencies have successfully assisted many first-time homeowners and have helped in the revitalization of numerous inner-city neighborhoods and rural communities. Our support of these efforts is illustrated by, among other things, permitting eligible nonprofit agencies to obtain insured financing under the same favorable terms as owner occupants.

Recently, there has been an expansion of nonprofits entering the housing provider arena. These include recently-established nonprofits as well as existing nonprofits diversifying their reach by adding affordable housing components to their mission. FHA encourages these efforts and, to the extent possible, will assist nonprofits in gaining housing provider experience and credibility in the local community.

To help with these efforts, and at the same time assure that nonprofits do not overextend their management ability and financial resources thus placing FHA at an unacceptable level of risk, this announcement contains information on acceptable affordable housing programs as well as credit evaluation guidelines. These will assist underwriters in analyzing the financial condition of a nonprofit and its ability to effectively manage an affordable housing program. These instructions, which supersede those in HUD Handbook 4155.1 REV-4 Chg-1, paragraph 2-17, are not designed to burden lenders with additional underwriting criteria, but rather to provide technical direction to those with limited experience in lending to nonprofits. All other underwriting requirements (borrower and collateral) remain valid and are important components in assessing the insurance risk on individual mortgages.

To be eligible as a mortgagor under FHA's programs and obtain the same insured financing percentage as owner-occupants, the nonprofit must be a tax-exempt organization, have a voluntary board whose members do not personally benefit and two years experience as a housing provider. Documentation as evidence the nonprofit meets the above criteria must be submitted to the local FHA office along with the description of its intended affordable housing program. While all local FHA offices will recognize any office's approval of the nonprofit's eligibility under these criteria, the affordable housing program itself must be separately approved by the local office. Please note that by statute only those nonprofits exempt under Section 501(c)(3) of the Internal Revenue Code of 1986 are acceptable; the nonprofit must include IRS "Letter of Determination" as verification of its tax exempt status. Eligibility criteria are further described in paragraph 1-5 of HUD Handbook 4155.1, REV-4, Change 1.

For any nonprofit lacking the full two years experience as a housing provider, consideration may be given to previous experience it has had in providing related community services. Upon approval by the local FHA office, the nonprofit may be permitted to obtain FHA mortgage financing, one property at a time, until it attains the housing provider experience required and successfully demonstrates its ability to either sell or rent these properties to qualified families. Hiring of experienced staff does not relieve the nonprofit of the experience requirements.

The nonprofit is to demonstrate:

- That its affordable housing program is consistent with FHA's guidelines as described below. This is determined by the local FHA office and is required regardless of the number of properties the nonprofit intends to finance with FHA mortgage insurance within the local FHA office jurisdiction, and

- That it has the management ability and financial capacity to effectively operate each program or project being considered. This is determined by the lender.

AFFORDABLE HOUSING PROGRAMS. Affordable housing programs administered by nonprofits must be approved by the local FHA office. Each affordable housing program must be a viable, well-run operation that successfully serves the housing needs of low- and moderate-income individuals and families.

Once the local FHA office is satisfied that the nonprofit's affordable housing program meets our objectives, it will issue a letter stating this to the nonprofit. Unless revoked by the local office, the affordable housing program itself is approved for a two-year period. For those nonprofits with limited housing provider experience, FHA may restrict the number of mortgages it will insure. A copy of the approval letter should be provided by the nonprofit to each lender considering making financing available to the nonprofit using FHA-insured mortgages. Acceptable affordable housing programs fall into the two categories described below:

Homeownership. Our target is homeownership. As such, we strongly encourage nonprofit agencies to make successful attainment of homeownership as the ultimate goal of their affordable housing programs. We recommend that nonprofits devise innovative approaches to providing additional avenues for first-time and underserved borrowers.

Long-term Rentals. We will also consider rental programs administered by nonprofit agencies as meeting the requirements of providing affordable housing. In some markets, long-term rentals may be the only effective way in which to provide affordable housing.

However, a nonprofit that appears to have taken on the role of a traditional, market rate landlord for cash-flow and income purposes without redistributing those funds back into its housing efforts will not have its program approved. Nonprofits are expected to fulfill their commitment to low- and moderate-income families.

Elements of Successful Affordable Housing Programs: Successful affordable housing programs vary considerably from area to area as nonprofits address local housing needs. Nevertheless, experience has shown that most successful programs have certain common elements. While none of the items listed immediately below are requirements for obtaining FHA approval of the affordable housing program, they serve as broad recommendations to nonprofits considering development of affordable housing.

- Pre-qualification. If the nonprofit will eventually sell the properties, either with new mortgages or through credit-qualifying assumptions, the nonprofit should pre-qualify potential homebuyers, thus ensuring a ready supply of buyers.

- Homeownership Counseling. The nonprofit should offer or obtain homeownership counseling for prospective homebuyers and also offer it after loan closing. If the nonprofit offers a lease-to-own arrangement, successful management of the monthly payments for a specified time should be a condition of the eventual sale to the homebuyer.

- Remaining Affordable. The PITI for the properties in question should remain in the "affordable" range for potential homebuyers/assumptors, i.e., the end product will be within the financial reach of those families it was designed to serve.

- Repair Reserves. If the nonprofit offers a rent with option to buy, the rental amount should include a repair reserve to limit payment difficulties once the homebuyer owns the property and is responsible for all repairs.

MANAGEMENT AND FINANCIAL CAPACITY. The analysis of the nonprofit's management ability and financial capacity to encumber properties using FHA mortgage insurance is performed by the lender providing financing. The lender must be able to conclude that the nonprofit will be able to support the mortgages for which it has applied and that it has the management resources available to administer the affordable housing program. This is particularly important with those nonprofit agencies that have embarked on large-scale programs while having only limited financial capacity or experience. Project sponsorship and management must be in keeping with the capabilities of the nonprofit. In making this determination, a number of elements, as described below, will be evaluated.

Program Administration. The lender must examine the track record of the nonprofit in developing/managing affordable housing and determine that the nonprofit demonstrates the skills and experience needed for the project being proposed. It must consider whether the project consists of lease-to-own properties or long-term rentals, as well as the market absorption on projects the nonprofit has completed. Further, beneficiaries of the affordable housing program itself may not be members of its board, employees, or others with an identity-of-interest to the nonprofit. Lenders may not approve a situation where such individuals are permitted to purchase or rent housing made available through the nonprofit using FHA insured mortgage financing.

Management of the Nonprofit. The nonprofit must be able to demonstrate that:

- Its Executive Director and/or key staff have the required experience in developing and administering affordable housing programs;

- It is reliable on the basis of its credit and community oriented reputation and performance or that of its principals and can demonstrate that it understands the responsibilities and obligations, including financial, that attach to sponsorship/operation of a project and its continuing successful operation.

- It is acting on its own behalf and is not under the influence, control, or direction of any outside party seeking to derive profit or gain from the proposed project, such as a landowner, real estate broker, contractor, builder, lender, or consultant. (Lenders are not to provide FHA-insured financing to nonprofits where there is anything less than an arms-length transaction between the nonprofit's officers and board members and any individual or corporation, including family members and business partners, that may profit from the program through provision of goods or services. Business relationships must be clearly disclosed. Nonprofit organizations that are established by for-profit enterprises must be similarly evaluated.)

Financial Analysis. The financial analysis of a nonprofit organization differs from that of a typical profit-oriented corporation in that it is the stewardship of the funds that is examined rather than profits and worth. The purpose of the financial analysis is to determine that the nonprofit has the financial capacity to manage the project and has financial support which will remain during the term of the mortgages.

Most nonprofit organizations utilize a "fund accounting" system. This system provides for the maintenance of separate accounts for funds that are associated with specific activities. Reporting on a fund account basis helps to segregate unrestricted (may be used for most any purpose) from restricted resources (may only be used for a specific purpose).

Performing a financial analysis properly requires the lender to obtain documentation to determine both the nonprofit's actual financial capacity and that it has demonstrated stability and proper cash management; these documents are to be included in the case binder submitted to FHA for insurance endorsement. (For relatively large-scale projects where multiple loans will close simultaneously, the local FHA office and the lender may agree to alternate methods of documentation submission to limit redundant paperwork.) If the underwriter is unsure of any of the terms or entries discussed below, including those on the attached financial analysis worksheet, he or she should contact a CPA for additional information. Please recognize that while the affordable housing program being administered by the nonprofit may be approved for a two-year period, the nonprofit's financial capacity must be evaluated for each mortgage being considered.

Documentation Requirements:

- Form IRS 990, Return of Organization Exempt from Income Tax. This is the tax form filed annually by the nonprofit. (Those with a gross income of less than $25,000 and churches are not required to complete this form but will file an identification portion of the return.) Among other things, Form IRS 990 and supporting schedules include information on the nonprofit's income, expenses, assets, liabilities and net assets in the past fiscal year. The lender must obtain the two most recent fiscal year's filings.

- Complete year-end financial statements (balance sheet, statement of activity, statement of cash flow) for most recent two fiscal years prepared in accordance with generally accepted accounting principles and reporting practices and must include the auditor's and treasurer's report and any supplementary schedules. This audit must be in conformance with OMB Circular A-133 "Audits of Higher Education and

Nonprofit Institutions" (if appropriate based on size of the nonprofit).

- Most recent 90 day year-to-date financial statement, along with a certification from a CPA or other financial professional attesting that this information accurately represents the financial condition of the nonprofit.

- Credit reports on the nonprofit itself as well as on the executive director/chief operating official(s) of the nonprofit organization. (This is to assure that those in leadership positions with the nonprofit exhibit personal responsibilities in managing financial affairs. These individuals will also be matched against CAIVRS and the LDP lists.)

- Corporate resolution delegating signatory authority. (The individual signing the loan application and other documents for the nonprofit agency is not personally obligated on the loan.)

- Complete articles of incorporation and by-laws of the nonprofit.

Funding stream considerations: Much of the analysis of the nonprofit's financial capacity revolves around its funding stream. The lender must consider the reliability and duration of the funding stream, and whether the primary sources of funding are competitive, whether the nonprofit's funding stream is from a mix of private and public sources, or only from public funds, and if other sources of funding are available should one or more be curtailed. The lender must also consider whether those funding sources permit overhead and administrative allowances as well as the amount of the nonprofit's money that will be encumbered by the downpayments on the loans.

Worksheet Analysis: We have developed a financial capacity worksheet to assist underwriters in evaluating the nonprofit's financial condition. Underwriters may use this worksheet or any similar form that captures the same information. The financial statements and Form IRS 990 provide the information necessary to complete this analysis. This data, in addition to the notes to the financial statements, are important in determining current financial strength as well as detecting any negative trends.

In conjunction with the questions below, the lender is responsible for describing how it arrived at the conclusion that the nonprofit was an acceptable mortgage risk and met FHA's eligibility criteria. If any of the answers to the questions below are "No," strong compensating factors will be necessary to approve the nonprofit as a mortgagor. The analysis must consider the effect of the proposed mortgage debt(s) on the nonprofit's financial condition. Nonprofits must disclose any pending mortgage applications, regardless of the type of financing being considered.

From the Balance Sheet:

1. Based on the number of mortgages being considered, does the nonprofit have unrestricted cash balances exclusive of lines of credit and rental income from the financed properties to support a 6 month reserve meeting the greater of:

   (a) 10 percent of principal, interest, taxes, and insurance (PITI) payments due each month on all mortgages; or
   (b) total PITI payments for the single largest mortgage?

2. Is the current ratio (current assets divided by current liabilities) approximately 2.00 or better? [This liquidity ratio gives an indication of the ability of the nonprofit to use its current assets to extinguish its current liabilities. As a rule, the higher the current ratio, the better. This ratio should also be examined as part of the trend for the nonprofit. Lines of credit are not to be considered in this ratio.]

3. Is total fund balance stable or increasing? [The fund balance is analogous to the equity section found on the balance sheet of a profit-motivated entity and should not be decreasing.]

4. Is the percentage of the nonprofit's total fund balance to the proposed mortgage debt at least 25%? [This is to determine if the nonprofit has sufficient financial size to operate the agency and the affordable housing project. Proposed mortgage debt would include any properties not complete and occupied.]

From the Statement of Activity:

1. Are the support and revenue accounts stable or, preferably, increasing? [Nonprofits with declining support and revenue accounts are unlikely candidates to engage in new affordable housing programs using FHA-insured financing.]

2. Is the trend of operating expenses in line with the support and revenue? [As a rule, expenses should not be increasing if support and revenue remain static or are decreasing.]

From the Cash Flow Information:

1. Have the cash flows from operating activities been positive? [It is the overall trend that is being analyzed, not a discrete point in time.]

PERFORMANCE AND APPROVAL TRACKING. Lenders must enter the nonprofit's federal tax identification number into CHUMS in lieu of a social security number. This will help us track multiple loans to the nonprofit as well track any defaults/claims when reported by the servicing lender into CAIVRS.

If you have any questions about this mortgagee letter, please contact your local FHA office.
Sincerely yours,

Nicolas P. Retsinas
Assistant Secretary for Housing-
Federal Housing Commissioner
Attachment

Suggested Nonprofit Financial Capacity Worksheet

	Current		
Balance Sheet Information	Year	199	199
1. Cash Balances--(Unrestricted Funds) (Actual cash or equivalents, and short term investments. Inventories and receivables should be excluded from this category. These funds cannot be restricted to any one fund and are considered "liquid.")			
2. Total Cash Balances--Restricted and unrestricted liquid funds			
3. Total Current Assets--Restricted and unrestricted assets that can be converted to cash within one year (e.g. cash and near cash equivalents, accounts receivable, marketable securities, prepaid expenses and inventories).			
4. Total Current Liabilities--Restricted and unrestricted liabilities that must be paid within one year (e.g. accounts and notes payable, income tax payable, and other short-term debt).			
5. Current Ratio (Current Assets divided by Current Liabilities) (line three divided by line four)			
6. Unrestricted Fund Balance			
7. Total Fund Balance			
Statement of Activity			
8. Total Annual Support and Revenue			
9. Total Annual Expenses (Operating Budget)			
Cash Flow Information			
10. Cash Flow from Operating Activities			

11. Total Net Increase or (Decrease) in Cash
    Also known as an increase/decrease in working

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